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Greenspan's "Irrational Exuberance" -vs- Bernanke's "Quite Concerned"

Some continuing e-comments of SKadvisors - By: J. Roger Shealy, CPA
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Earlier this week, in discussing escalating asset prices, we reviewed the context of Greenspan's most famous utterings – "Irrational Exuberance." The term was used in a black-tie dinner speech entitled "[The Challenge of Central Banking in a Democratic Society](#)" before the American Enterprise Institute in Washington, D.C., on December 5, 1996. More than ten pages into this long speech, Greenspan posed a rhetorical question: "But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

Immediately after he said this, the stock market in Tokyo, which was open as he gave this speech, fell sharply, and closed down 3%. Hong Kong fell 3%. Then markets in Frankfurt and London fell 4%. The stock market in the US fell 2% at the open of trade.

Fast forward to today, or March 14, 2006 to be exact, – In his written response to Congress, Ben Bernanke said, "I am quite concerned about the intermediate to long-term federal budget outlook." His concern was expressed as the White House is projecting the budget deficit to balloon to a new record of \$423 billion (that's billion with a "B").

We've discussed, at length, how demand for U.S. Treasury bills/bonds/notes has an effect on interest rates (see linked article "[Greenspan's Conundrum – a true enigma or perpetuated ignorance?](#)"). What we've not spent much time reviewing is the supply side - and supply is just as much a part of the "price equation" as demand (prices increase when demand exceeds supply – and prices decrease when supply exceeds demand.... ***by the way, this also holds true in the real estate market!***). In the case of bonds, yield (interest) increases when supply exceeds demand – and interest decreases when demand exceeds supply.

In our republic, the government is a reflection of its citizens – and the same is true in financial stewardship. Just as Americans have become more and more accustomed to personal debt, so has our government. Just as we now spend more than we earn ([for 2005, the savings rate in America was negative](#)), the government is spending more than it receives in revenues – result: budget deficits and deficit spending.

So why didn't the markets react to Bernanke's "[Quite Concerned](#)" phrase like they did when Greenspan uttered his infamous term "Irrational Exuberance"? Other than a few comments by some boring economic pundits, there was no reaction. Or maybe there was a reaction – maybe it was too subtle to notice and too quiet to hear. Earlier this month, the U.S. Treasury auctioned off its 10YR Treasury Notes – strangely missing in the auction hall was a host of foreign buyers – foreign buyers, who in previous auctions, had quite the appetite for our debt. Could it be that we have out-supplied the market? Or maybe the quality and character of the bonds is not as "comforting" as in the past.

Bernanke is right (at least in this case). We should all be "quite concerned" with increasing budget deficits. This behavior will ultimately have an effect on our U.S. economy. As more debt spending is "needed," more bonds are issued (increase in supply). As more budget deficits are created, the less investors will find our debt attractive (decrease in supply). The effect of reduced demand and increased

supply is higher yields (interest rates). While the Federal Reserve can manipulate certain interest rates (i.e. Federal Funds rate), they do not directly affect long-term borrowing rates.

Only we, the people, can bring about the change necessary to correct this imbalance. We begin by getting our own house in order. Following are some simple ideas:

1. Creating budgets to ensure we do not over-extend ourselves (spending controls)
2. Planning for our financial future (401(k), IRA(s) etc. contributions)
3. Developing proper investment strategies
4. Avoiding personnel debt (if you don't have it, don't spend it)
5. NEVER using debt on long-term assets to fund consumer spending (home equity extraction for personal use)
6. Help your neighbor! (make charity a part of your life)

Then we demand the same of our government. This is this best way to control inflation and keep off the Fed's interest rate rollercoaster ride.

Though the markets appear deaf to Bernanke's concern, we at *SKadvisors* take the warning seriously. As always – we'll be watching.

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS. WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER.

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